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Insurance insights

CASE NOTE

The insurer strikes back

The recent NSW Court of Appeal decision in Stealth Enterprises trading as *The Gentleman's Club v Calliden Insurance Limited* (delivered on 5 April 2017) provides further guidance on:

1. What must be disclosed by insureds when entering into and renewing contracts of insurance; and
2. The burden of proof on insurers in relation to establishing what the insurer would have done, had the relevant disclosure been made.

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Case: *Stealth Enterprises Pty Ltd t/as The Gentlemen's Club v Calliden Insurance Limited* [2017] NSWCA 71

Background

Stealth operated an escort agency and brothel in the ACT. The brothel was badly damaged by fire. Stealth made a claim under its property insurance policy with Calliden for damage to the brothel premises and business interruption losses. Calliden denied the claim. It contended that Stealth breached its duty of disclosure under Section 21 of the Insurance Contracts Act (the 'Act'). Calliden argued that Stealth had failed to disclose that:

1. The brothel was not registered under the Prostitution Act at the time of renewal; and
2. Its director (and guiding mind) and his brother, who was the brothel manager, were members of the Comancheros, an outlawed motorcycle gang.

Stealth challenged Calliden's denial of indemnity in the Supreme Court of NSW. Calliden argued that Stealth's non-disclosure was fraudulent, entitling it to void the policy from the outset or at least from the date of renewal. Alternatively, it argued that it was entitled to reduce its liability in respect of the claim to nil on the basis that it would not have accepted the risk or renewed the policy had these matters been disclosed by Stealth.

As to whether there had been non-disclosure, Stealth argued that neither matter was relevant to Calliden's decision whether to accept the risk. It contended that the absence of questions in the proposal form about such matters made this clear.

Decision at first instance

At first instance, Justice Schmidt accepted the evidence of Calliden's underwriters that membership of the Comancheros as well as the lapsing of the brothel's registration were relevant to Calliden's decision to issue and renew

the policy. Even though there was no evidence from Stealth on the issue, Justice Schmidt inferred from the other evidence that Stealth knew that these matters were relevant to Calliden's decision. She also found that a reasonable person in the circumstances would have considered them to be relevant to Calliden's decision.

Justice Schmidt was not satisfied on the evidence that there had been fraudulent or reckless non-disclosure by Stealth. On the other hand, her Honour found that there had been innocent non-disclosure.

On the issue of what Calliden would have done had the matters been disclosed, Justice Schmidt noted that Calliden's underwriting guidelines were silent on the issue. Notwithstanding this, her Honour accepted the evidence of Calliden's two underwriters that they had the authority to decline the risk. She also accepted their evidence that membership of an outlawed bikie gang by office holders of Stealth constituted a significant and unacceptable risk which they would have declined to cover.

On that basis, Justice Schmidt found that Calliden was entitled, under section 28(3) of the Act, to reduce its liability in respect of the claim to nil.

The appeal

Stealth appealed. The issues before the Court of Appeal were:

1. Whether Stealth knew, or a reasonable person in the circumstances could be expected to know, that the association between the director and his brother and the Comancheros bikie gang was relevant to Calliden's decision whether to accept the risk by renewing the policy, and if so, on what terms;
2. Whether, if that association had been disclosed to Calliden, it would not have renewed the insurance;
3. Whether at the time of renewal, Stealth knew that the registration of the brothel had lapsed or not been maintained; and
4. Whether, if the fact of the lapse of registration had been disclosed to Calliden, it would not have renewed the policy or otherwise insured the premises against property damage at the time of the fire.

The Court of Appeal's decision

Stealth's appeal was allowed. In relation to the first issue, the Court noted that the test for disclosure in section 21(1)(b) requires an objective standard, that of a hypothetical reasonable person. In answering that question, it was necessary to consider whether, having regard to the circumstances affecting Stealth, a reasonable person could be expected to know that the association with the Comancheros was relevant to Calliden's decision to accept the risk.

The Court examined number of matters the hypothetical brothel owner at the time Stealth renewed the policy should have known. It concluded that a reasonable person could not to be expected to know that the fact of the brothers' membership of the Comancheros, without more, was relevant. The Court found that it was the sort of association the insurer would expect and take into account as part of the general risk of insuring a brothel; and there were no particular circumstances related to the association, such as the making of threats, that took it outside that general risk. The Court was also took the view that if it was relevant to Calliden to know of the fact of any

general association between the insured or its directors and any particular activity or organisation, a reasonable person might reasonably have expected that there would have been questions addressed to that subject.

On the second issue, the Court found that the trial judge had erred in being satisfied that Calliden would not have renewed the policy. In that regard, it was determined that the evidence, considered as a whole, did not establish that Calliden, had it been made aware of Stealth's association with bike gangs, would have declined to renew Stealth's policy. Of particular importance in the Court's decision was the fact that the underwriter's supervisor, who had significant influence in relation to decisions concerning whether or not to renew, was not called to give evidence.

Regarding the third issue, the Court found that Justice Schmidt did not err in drawing inferences which were available in the absence of evidence from the director or his brother to the contrary.

In relation to the fourth issue, the Court found that there was evidence from which the Court might reasonably and sensibly infer that on the hypothesis that there had been disclosure, the insurer would have been on risk at the time of the fire because Stealth would have remedied the problem of its registration. The Court accordingly found that the primary judge erred in finding that Calliden was entitled to reduce its liability to nil pursuant to section 28(3).

Significance

The decision is important for a number of reasons:

1. It confirms that the duty of disclosure is not restricted to disclosing matters upon which specific questions are asked in the proposal form. That is because there is a general duty to disclose all matters relevant to the insurer's decision.
2. However, it must be kept in mind that the test for disclosure in section 21 of the Act is whether a reasonable person in the circumstances could be expected to know that the matter was relevant to the insurer's decision to accept the risk. In answering that question, care needs to be taken in assessing all of the circumstances affecting the actual insured, whilst keeping in mind that the ultimate question turns on what could be expected of a reasonable person.
3. It confirms that the Court will look to whether the relevant underwriter would have accepted the risk, and if so on what terms, rather than what underwriters in general would have done. In doing so, great care needs to be taken by the underwriter/insurer to establish, on the balance of probabilities, what decision would have been made had the relevant disclosure occurred. This likely requires calling all relevant employees to give evidence as to the underwriting process at the insurer at the relevant time, including those employees who had the ability to influence or decide whether or not the risk was accepted (e.g. a supervisor). The evidentiary onus will likely be particularly heightened in circumstances in which the underwriting guidelines do not specify the risk the subject of the disclosure.

PLEASE CONTACT PRINCIPAL ROBERT CRITTENDEN IF YOU HAVE ANY QUESTIONS REGARDING THIS DECISION.